

Economic Report

November 1987

Commentary
on Pertinent
Economic
Issues

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Picking Up The Pieces

Besides shattering many dreams and expectations, the stock market's crash has fragmented opinions on the outlook for the U.S. economy and what, if anything, the government should do about it—not to mention on the future course of stock prices, interest rates, and the foreign exchange value of the dollar. For every economist who says that the right policy prescription is for Washington to slash its budget deficit, there's another who warns that administering fiscal restraint at this time would risk a repetition of what happened in the 1930s. On the other hand, while many economists now believe that a recession is likely in 1988, there are more than a few who think that another year of growth is in store, and that the stock market's plunge will not prevent the expansion from continuing. Some applaud the drop in interest rates and the value of the dollar that occurred in the wake of the market's plunge as cushions against a possible recession, while others have become concerned that these developments are harbingers of a higher rate of inflation.

Here are some of the questions that have arisen in the wake of the market's crash:

Did the stock market crash because of Washington's budget deficit?

The reasons for the market's crash are numerous and complex, and, no doubt, concern over the budget deficit was one of them. However, the budget picture was no different on Monday, October 19, than it was on the previous Friday—or, for that matter, all during the month. If anything, Washington's budget deficit in the 12 months ending September 30, 1987, fell to its lowest annual level since 1982. Not only that—both stock prices and the economy rose for five years straight, a period that coincided with rising budget deficits!

Then why all this talk about the need for the President and the Congress to cut the budget deficit?

The markets have become concerned about the fact that the United States for a number

of years has been consuming more than it has been producing—and, in effect, borrowing from foreigners to finance this excess. According to this line of reasoning, a lower budget deficit will result in less Federal borrowing, which means less reliance on foreign funds. Interest rates can then move lower which will push down the value of the dollar and help reduce our trade deficit which will cushion us against a recession.

Aren't there risks in this strategy?

Sure, there are! For one thing, the deficit could be cut too sharply, resulting in more fiscal restraint than the economy could handle. For another, if the dollar goes down too rapidly, it will discourage even a reduced inflow of foreign funds—not to mention causing withdrawals. More inflation could arise from the lower-valued dollar as imported goods go up in price, and domestic manufacturers use this as an opportunity to raise their own selling prices.

By reducing the value of the dollar in foreign exchange markets, isn't Washington, in effect, trying to export our recession to our trading partners, similar to the intent of the Smoot-Hawley Tariff Act of 1930?

First of all, the value of the dollar in foreign exchange markets is determined by more than Washington's wishes, so it is not all that clear that this is deliberate policy on our part. Secondly, if other countries were to respond by taking steps to counter the falling dollar, they would undoubtedly employ, among other strategies, a policy of reducing their interest rates. This would help them by stimulating their economies, while helping us by providing better export markets for us and for our trading partners.

Why all this worry about the strength of the U.S. economy? The latest statistics show that business was expanding at a pretty good clip before the market's plunge.

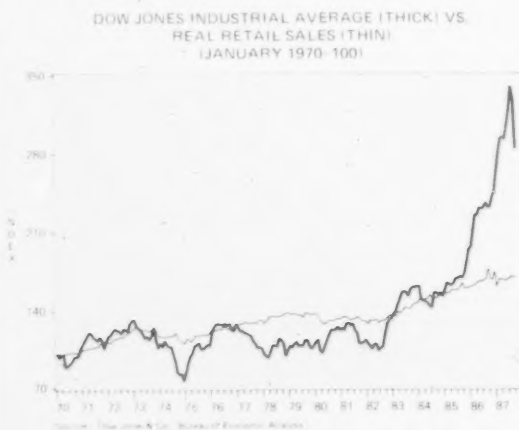
Storm clouds were gathering on the horizon well before the market's plunge in the form of a rise in the rate of inflation (which cuts into buying power), rising interest rates

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(which reduces borrowing power), and declines in auto sales and homebuilding, which, as you can imagine, affect a wide variety of industries. Keep in mind also that the stock market crash of October 19 did not represent a sudden reversal in the market's trend; stock prices began to slide nearly two months earlier. Lower stock prices reinforced the downward trend in spending by reducing both the wealth of those who are in the market, and the confidence of the great majority who are not, but who are aware of market trends.

But the surge in stock prices that took place between the beginning of the year and August 25 did not lead to a similar surge in spending, so why should the decline lead to a reduction in spending?

Spending levels might have been even lower if the stock market hadn't gone up earlier, since personal savings are low and debt usage is high. Many people looked upon the rising value of their stocks as a substitute for savings.



The stock market declined by about the same percentage in 1962, and yet there was no recession for over seven years, so why can't we avoid a recession this time?

There are many differences today compared with a quarter of a century ago. For one thing, the economic recovery then under way was about one year old, meaning that it was strong enough to withstand such a shock. This year's crash finds the expansion a senior citizen by business cycle standards. Indeed,

when October came to an end, the expansion set a new record for peacetime longevity of 59 months—more than twice as long as average. Additionally, the 1962 stock market decline was spread out over a period of months, not concentrated in a few hours as this one was. Thus, it did not make the headlines in the newspapers, the cover stories of national magazines, nor did it receive the television treatment that this decline did.

In the wake of the fall in the value of the dollar, won't the drop in the trade deficit be enough to offset any softness in domestic spending?

One should not expect too much from a declining trade deficit for several reasons: First, our trade position almost always improves when the U.S. economy is in a recession, since reduced consumption levels in general also lead to fewer imports. Second, exports represent only about 11 percent of gross national product, thus are unlikely to offset massive weaknesses elsewhere. And exports may not rise much this time because our trading partners are either growing slowly themselves, or have restricted the inflow of foreign goods to improve their own balance of payments.

As you know, the stock market crash led to a drop in interest rates. Why wouldn't this tend to prevent a recession—especially considering that bonds, whose prices went up as interest rates fell, are widely held?

Let's take the second part first. Even after the crash, the value of stocks still exceeds the value of bonds. In addition, stocks at mid-November were about 28 percent below their August peaks, while bond prices were up only about eight percent. Households own a greater percentage of stocks outstanding than they do bonds. Thus, the drop in the value of household-owned stocks from their peak in August (over \$750 billion) far outweighs the increase in the value of household-owned bonds (about \$75 billion) that occurred in the wake of the drop in interest rates beginning on October 19. As for the decline in interest rates themselves, while this might make it easier for people to borrow, it is not all that clear that they will want to borrow until they see how their

financial situation will be affected by the stock market's crash.

But shouldn't the rise in bond prices, along with the drop in interest rates—not to mention the reduced concern over inflation that has followed in the wake of the market's crash, be considered good news for the economy which should be factored into the outlook?

There is no doubt that these developments are good news. However, past experience has shown that bad news affects the economy before good news does, and that sudden, unexpected events, such as a stock market crash, can have a pretty rapid impact. For example, the drop in oil prices between October 1985 and April 1986 was good news for those who consume energy but bad news for those who produce it—and it was the production side that reacted first by cutting back output, thus holding down overall economic growth. In early 1980, the credit controls imposed by the Federal Reserve were widely misunderstood and led to an immediate downturn in consumer spending, thus plunging the economy into recession. And the oil embargo and quadrupling of oil prices that took place in October 1973 caused the economy to go into recession barely two months later.

If we do have a recession in 1988, is it conceivable that it could turn into something really bad?

We don't anticipate anything like the economic catastrophe that occurred after the 1929 crash. For one thing, the government is a much bigger factor today, and while many complain about the government, it helps stabilize economic activity in times like these. There are income maintenance programs such as Social Security and unemployment insurance that keep consumers' purchasing power from collapsing as it did in the 1930s. There are also many legal and regulatory safeguards that will keep confidence in our financial system, besides the fact that the market today is dominated by big institutional investors who are better able to deal with steep downturns.

After the experience of the 1930s, we learned that the government should rely

primarily on fiscal policy to stimulate the economy, since monetary ease, by itself, did not seem to be able to do the job. Yet, this time around, we are faced with the loss of this fiscal tool, since, in today's environment, the government could not deliberately increase its budget deficit. That being the case, is there a risk that we will be unable to come out of recession relatively soon?

Notwithstanding the lessons of the past, today's circumstances dictate a *reduction* in Washington's budget deficit for reasons noted earlier: Less government borrowing means lower interest rates, lower interest rates will let the dollar drift lower and; that, in turn, will reduce our trade deficit, providing a cushion against a long recession. However, I would add that it is more important for the politicians to develop a credible long-range plan to reduce the deficit than it is to take a big chunk out of the deficit for the current fiscal year.

Is there anything else we should have learned from the market's debacle?

Yes. Panic is a condition experienced by many living creatures. In the case of fishes, birds and animals, panic can start with a sudden disturbance to the environment. A herd of animals may be scared into panic by a shotgun blast; for man, the causes are more complex. We have had many panics in recorded history, the most famous of which, besides the market crash of October 1929, was probably the rapid rise and then plunge of the price of tulip bulbs in Holland during the first third of the seventeenth century.

Looking back over the accounts of the stock market's activity in the months and weeks leading up to the crash, one factor to consider is the role of the media. In the days and weeks prior to the crash, it was not uncommon to find in the financial press a comparison of the pre-crash declines with past history. It seems to me that this focused investors' attention on the relative importance of each major downward move in stock prices until one day, October 19, most came to the same conclusion that the time had come to get out. While this kind of reporting sells newspapers and magazine, unfortunately, it also sells stocks. ■



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**Economic
Report**

January 1988

Commentary
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Irwin L. Kellner
Chief Economist

Economic Forecast For 1988*

The new year finds the business outlook murkier than ever. There is widespread disagreement among economists over where we are today—not to mention regarding where we are heading over the balance of 1988. The range of expectations hasn't been this wide since the end of 1982. Interestingly, the United States economy reached a major turning point at that time (the end of the 1981-82 recession), and it may well be at another critical juncture (the onset of a new recession) today.

One aspect of the business outlook seems to unite the forecasters. This is the feeling that economic growth will slow significantly during 1988—especially in the first half of the year. Some think business will pick up again by the summer, while others feel the economy will be sluggish all year. In my opinion, it would be prudent to expect a recession this year—not a bad one, but clearly a change from the growth environment of the past five years.

Recession Is At Hand

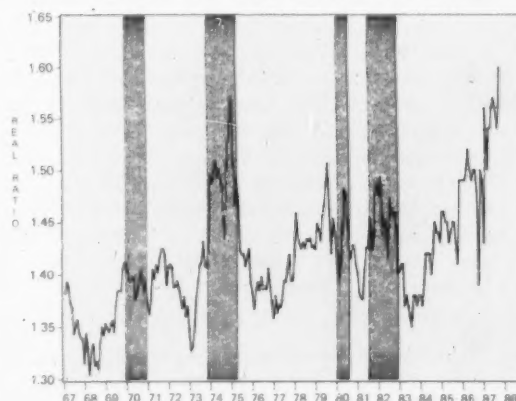
As many may already be aware, my forecast of a recession in 1988 is not a recently adopted position. It predates not only the stock market's plunge of last October—but even the slide that began two months earlier, in late August 1987. Indeed, it goes back to last spring. At that time, we saw a number of signs that in the past have signaled the onset of recession:

- The ongoing expansion had become twice as long as the average peacetime upswing, meaning that it was becoming increasingly susceptible to being derailed;
- Fiscal policy was tightening sharply, since the government's budget deficit was in the process of contracting by one-third;
- Monetary policy had turned restrictive, whether one looked at the money supply, which stopped growing in the

spring, or at short-term interest rates, which had actually bottomed out in early October 1986;

- Long-term rates began shooting up in April 1987, as bond buyers became aware that inflation had returned;

CHART I
RETAIL TRADE REAL INVENTORY-SALES RATIO



- The rise in the rate of inflation was not matched by an equivalent increase in wages and salaries, leading to a drop in people's buying power;
- The combination of reduced buying power and less borrowing power, along with the generally high level of debt and low rate of savings caused consumers to reduce their purchases of autos and housing—two mainstays of our economy;
- Consumer spending in general began to falter, although it was offset for a while by stepped-up production for exports in the wake of the lower-valued dollar.

Because of this last factor, as well as because the stock market had not as yet reached a peak, we believed that the U.S. could avoid a recession in 1987. This appears to have been the case—at least according to preliminary data covering last year's gross national product. However, a closer examination of these statistics, as well as an assessment of the developments that have taken place in the stock market since the August peak suggests that the five-year expansion has just about run out of string.

*Based on testimony given before the U.S. Congress, Joint Economic Committee, hearing on the economic outlook and policy options for 1988, January 22, 1988.

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The signal sent by the stock market's decline should not be ignored. For one thing, while not every decline in stock prices has led to a recession, every recession in the past half century has been preceded by a drop in the stock market. What is more, the only time in this century when a plunge in stock prices the size of the decline between August 25 and October 19, 36 percent, was *not* followed by a recession was during World War II, when the military buildup kept the economy rising even though the market had fallen by over 40 percent.

Consumers Are Retrenching

Since we are not on a wartime footing today, it seems reasonable to expect the negative impact of the market's fall to spread throughout the economy. Those who own stocks are clearly less wealthy today than they were last August, while they, and the vast majority of people in the U.S. who don't own stocks, are surely less confident. The record shows that these developments lead to reduced outlays—which can be seen from the statistics describing consumer spending. Nominal retail sales were about two percent lower in December 1987 than they were back in September 1986, while "real" sales, after adjusting for inflation, were down by more than twice that much. Taking the volatile auto sector out of the picture finds real retail sales down by two percent in the last ten months alone.

On the other hand, production of goods destined for final consumers has actually sped up since summer 1986. While real retail sales have been falling, output has climbed by five percent. Not surprisingly, inventories are beginning to pile up. The Commerce Department's latest tabulation shows a sharp two percent increase in total business inventories in the past two months. And since total business sales have actually fallen during this time, the important ratio of inventories to sales has begun to rise.

As is usually the case, the backup of unsold goods is most prominent at the retail level. Not only has the ratio of inventories to sales adjusted for inflation been climbing sharply since autumn 1986, but it is higher now than at anytime in the past 20 years—a period spanning four recessions (Chart I)! Merchants must now be in the process of putting on the brakes, because in the past few months, wholesalers' inventories have begun to shoot up, causing their I-S ratios to rise from the 13-year low reached this past summer.

At the manufacturing level, inventories have been rising for about a year, but since sales have gone up even faster, producers' I-S ratios are still falling. However, once wholesalers decide that their stockpiles are too high and begin to reduce their orders, factory sales will lose some of their zip. This will leave producers in particular—and the economy in general—dependent on capital goods and exports for continued growth.

It may not be enough. For one thing, these two sectors combined amount to less than one-quarter of the gross national product. This means that output of capital goods as well as goods destined for export would

have to grow even faster than in 1987 to offset the ongoing weakness in consumer spending, which accounts for two-thirds of the GNP.

There is no disputing the fact that production of these goods is in a sharp rise. Output of business equipment jumped six percent in 1987, responding to a surge of similar magnitude in business spending for capital goods. And a recent government survey of business spending plans suggests that an even greater rise might be in store for 1988. However, this increase might not come to pass, since most of it represents spending on equipment, which can easily be postponed or even cancelled, should economic conditions warrant it.

Exports Can't Help Much

Most of the hopes for avoiding a recession are therefore being pinned on exports. After rising only slightly in 1986, exports in the first 11 months of 1987 shot up 15 percent. But to offset just a flattening in consumer spending—which is nearly six times as large—exports would have to rise about one-third faster this year than in 1987. Notwithstanding the fact that the dollar is worth only about half as much today as it was three years ago when compared with the major industrial currencies, it won't be easy for goods producers to achieve this objective.

For one thing, U.S. industry has already shifted a lot of

its productive capacity overseas, responding to the earlier strength in the dollar, as well as lower labor and other costs. Whatever comes out of these offshore facilities will not benefit the U.S. economy. For another, while average domestic operating rates remain only around 82 percent, well below peaks reached in earlier cycles, capacity utilization in a number of industries—especially those involved in exporting—are much higher. The paper materials industry, as an example, is operating at 99 percent of capacity, a near record, while other parts of this industry are operating at rates in the mid-90s. Textile mills are running at better than 94 percent of capacity, while the iron and steel industry is at 91 percent. Aerospace, chemical materials, rubber and plastics are all at 88 percent.

Besides putting a lid on export growth, these high rates of capacity use have led to significant price pressures. Industrial raw materials have climbed nearly 40 percent from their August 1986 lows. At the producer, or wholesale, level, this surge has translated into an accelerating rise in prices of intermediate goods, excluding food and energy. Last quarter, for the sixth quarter in a row, this index rose at a faster pace than it did in the preceding quarter (Chart II).

With prices of imported goods up at least 10 percent over the past year, the only thing that has prevented these pressures from spilling over into the consumer price index (which still rose four times faster in 1987 than it did in 1986) is the softness in consumer demand. If the economy manages to avoid a recession this year, these bottled-up inflation pressures would seem likely to surface.

Another byproduct of continued economic growth this year would be a renewed decline in the dollar. This is because, instead of shrinking as might be expected in a recession year, imports will remain high, owing to the expansion in buying power that would accompany continued economic growth. The resulting lack of progress in bringing down the trade deficit is what could pressure the dollar. Needless to say, a lower dollar, combined with more inflation, would boost interest rates and send the stock market tumbling once again. The net result: an even worse recession in 1989.

On the other hand, a recession in 1988 would not be without a silver lining. To be sure, there are people who will lose their jobs in a recession, while many businesses will sustain reduced sales and earnings. For these folks, the "benefits" of recession are, understandably, small consolation. Nonetheless, there are some pluses to be aware of, one of which will be a continued bottling up of inflation, since neither business nor labor will be able to raise prices and wages very much when the economy is soft.

As it becomes evident that inflation pressures are being vented, the financial markets will become less tense, and interest rates should begin to fall. This decline

(Continued)

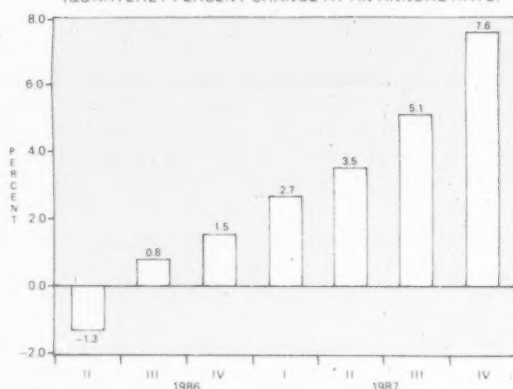
January, 1988
MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In \$ Billions

	1987				< Actual Projected >		1988				YEAR 1988	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	4377.7	4445.1	4524.0	4598.0	4486.4	5.9	4610.7	4637.7	4674.4	4722.3	4661.3	3.9
GNP: \$82	3772.2	3795.3	3835.9	3875.1	3819.6	2.9	3841.8	3820.0	3809.3	3802.4	3818.4	0.0
% Change, Annual Rates	4.4	2.5	4.3	4.2	2.9		-3.4	-2.3	-1.1	-0.7	0.0	
Consumption \$82	2475.9	2487.5	2520.7	2496.6	2495.2	1.8	2501.2	2505.7	2501.8	2492.8	2500.4	0.2
Durables \$82	375.9	385.4	406.9	384.4	388.1	1.2	384.4	383.8	380.0	376.0	381.0	-1.8
Non-Durables \$82	883.2	879.0	875.7	865.6	875.9	-0.2	864.6	863.1	860.6	854.2	860.6	-1.7
Services \$82	1216.9	1223.1	1238.1	1246.6	1231.2	3.5	1252.2	1258.8	1261.2	1262.7	1258.7	2.2
Investment \$82	671.8	673.7	681.9	714.2	685.4	4.8	679.5	657.2	638.5	624.8	650.0	-5.2
Non-Residential \$82	426.0	437.9	463.8	459.6	446.8	0.7	455.4	453.6	446.6	439.3	448.7	0.4
Producers Durable Equip. \$82	305.6	317.5	336.6	330.4	322.5	2.9	327.3	326.6	320.7	316.4	322.7	0.1
Structures \$82	120.4	120.4	127.2	129.2	124.3	-4.6	128.1	127.0	125.9	122.9	126.0	1.4
Residential \$82	198.2	196.8	193.5	196.3	196.2	-0.1	186.2	186.3	185.7	187.4	186.4	-5.0
Inventory Changes \$82	47.6	39.0	24.6	58.3	42.4		38.0	17.3	6.2	-1.9	14.9	
Net Exports \$82	-135.2	-132.7	-138.5	-130.7	-134.3		-121.9	-115.2	-108.7	-103.8	-112.4	
Government Purchases \$82	759.6	766.7	771.6	795.0	773.2	2.5	783.0	772.3	777.7	788.6	780.4	0.9
Federal Defense \$82	257.4	263.5	268.3	267.8	264.2	5.4	262.0	256.2	253.5	254.3	256.5	-2.9
Federal Civilian \$82	69.9	69.1	67.9	86.7	73.4	-10.2	75.3	68.3	74.3	82.1	75.0	2.2
State & Local \$82	432.3	434.1	435.4	440.5	435.6	3.2	445.7	447.8	449.9	452.2	448.9	3.1
Final Sales: \$82	3724.6	3756.3	3811.3	3816.8	3777.2	2.1	3803.8	3802.7	3803.1	3804.3	3803.5	0.7
% Change, Annual Rates	-2.3	3.4	6.0	0.6	2.1		-1.4	-0.1	0.0	0.1	0.7	
Domestic Demand: \$82	3907.4	3928.0	3974.4	4005.8	3953.9	2.5	3963.7	3935.2	3918.0	3906.2	3930.8	-0.6
% Change, Annual Rates	2.5	2.1	4.8	3.2	2.5		-4.1	-2.8	-1.7	-1.2	-0.6	
GNP Price Index (1982=100)	116.1	117.1	117.9	118.7	117.4	3.0	120.0	121.4	122.7	124.2	122.1	3.9
% Change, Annual Rates	4.2	3.5	2.8	2.7	3.0		4.5	4.7	4.4	4.9	3.9	
Consumer Price Index (1967=100)	335.0	339.0	342.3	345.3	340.4	3.7	349.1	352.5	355.6	358.2	353.8	4.0
% Change, Annual Rates	5.3	4.9	3.9	3.6	3.7		4.5	4.0	3.6	3.0	4.0	
Total Personal Income	3662.0	3708.6	3761.0	3851.5	3745.8	6.0	3856.6	3890.0	3941.5	3995.4	3920.9	4.7
Disposable Personal Income	3125.9	3130.6	3195.3	3272.6	3181.1	5.3	3298.8	3327.1	3372.9	3418.4	3354.3	5.4
Savings Rate	4.4	3.0	2.8	4.9	3.8		4.3	3.9	4.3	4.7	4.3	
Unemployment Rate	6.7	6.2	6.0	5.9	6.2		6.0	6.4	6.8	7.2	6.6	
Indus. Production (1977=100)	126.9	128.2	130.9	133.0	129.8	3.7	130.1	125.7	123.0	120.1	124.7	-3.9
Housing Starts (000)	1794.7	1611.7	1623.0	1516.7	1636.5	-10.0	1515.1	1487.5	1475.3	1500.3	1494.5	-8.7
Dom. Auto & Lt. Truck Sales (000)	10208.0	11285.0	11937.7	10393.7	10956.1	-7.7	9906.0	9815.1	9506.3	9022.2	9562.4	-12.7
Corporate Pre-Tax Profits	257.0	268.7	284.9	274.6	271.3	17.0	251.8	246.9	239.2	247.7	246.4	-9.2
- Taxes	128.0	134.2	143.0	141.1	136.6		118.3	114.8	110.0	111.9	113.8	
Net Profits	129.0	134.5	141.9	133.5	134.7	6.2	133.5	132.1	129.1	135.7	132.6	-1.6
- Dividend Payments	90.3	92.4	95.2	95.2	93.3	7.5	98.9	100.4	101.5	102.4	100.8	8.1
Undistributed Profits	38.7	42.1	46.7	38.3	41.4	3.5	34.6	31.7	27.6	33.3	31.8	-23.2
+ Depreciation	340.0	342.5	345.5	347.7	343.9		352.0	355.4	357.6	358.5	355.9	
- Inventory Profits	11.3	20.0	17.6	8.0	14.2		8.6	8.8	8.5	8.4	8.6	
Net Cash Flow	367.4	364.6	374.6	378.0	371.1	-1.1	378.0	378.3	376.7	383.4	379.1	2.1

*Forecast

should be aided by an easing of Federal Reserve monetary policy, as usually happens once a recession is underway and inflation is perceived as less of a threat. These lower rates need not push the dollar down, since our foreign trade deficit would be improving. Thirty percent of the goods we consume is imported, so it stands to reason that declining demand will result in fewer imports as well.

CHART II
PRODUCER PRICE INDEX - INTERMEDIATE GOODS
EXCLUDING FOOD AND ENERGY
(QUARTERLY PERCENT CHANGE AT AN ANNUAL RATE)



As the dollar stabilizes, foreign funds will return to the U.S. Declining interest rates should encourage both foreign and domestic funds to flow into the stock market. Once the stock market gets out of its rut and begins to rise on a sustained basis, wealth and confidence will return, laying the groundwork for a new economic recovery.

No Policy Options

One final point. Because this is a presidential election year, you might be wondering what,

if anything the Administration might be able to do to delay the onset of this recession, since the record shows that bad times in years divisible by four tend to lead to a change in the party occupying the White House. The answer, in my opinion, is not very much.

For one thing, we may already be in a recession, in which case it is obviously too late. But even if we are not, there do not seem to be any options open to the Administration at this point. Fiscal policy is virtually powerless. Any efforts to ward off a recession (by either spending increases or tax reductions) would be difficult to implement, because they would involve deliberately increasing Washington's budget deficit at a time when most everyone wants to see the deficit shrink. Monetary policy might be used—but only *after* a recession gets underway. It does not seem likely that the financial markets will tolerate lower interest rates and rapid money growth engineered by a central bank, all of whose members have been appointed by the party in the White House, until business conditions require them.

A third policy tool is foreign exchange. Pushing the dollar lower, thereby making exports cheaper and imports even more expensive, could ward off a recession. However, as the Administration learned several months ago, it could also discourage the inflow of foreign funds needed to finance our current deficits. In turn, this could lead to higher—not lower—interest rates by adding to domestic inflation, and, perhaps, to another plunge in stock prices. ■



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Economic Report

March-April 1988

Commentary
on Pertinent
Economic
Issues

Irwin L. Kellner
Chief Economist

Up or Down?

How can we tell where we're going, if we can't agree on where we've been? This year's first quarter is now in the record books, yet economists are divided regarding the direction the economy has taken. Most economists feel that business continued to grow in the first quarter—albeit at a slower pace than in the fourth. However, a vocal minority insists that the economy reversed course around the turn of the year, and has contracted, instead. It could make a difference to the outlook if the gross national product rose or fell in the January-March period.

Interestingly, those who think the economy is still growing point to such statistics as the leading indicators. They had fallen three months in a row from October through December, but upon release of the January reading (which was down), December's posting was revised to show an increase. February's reading was up, too. Thus, this key forward-looking index is no longer declining the requisite three consecutive months that lead to talk of recession. Another statistic that boosted the bulls even more was the February labor force data, which showed a whopping 531,000 leap in nonfarm payroll employment—more than twice market expectations.

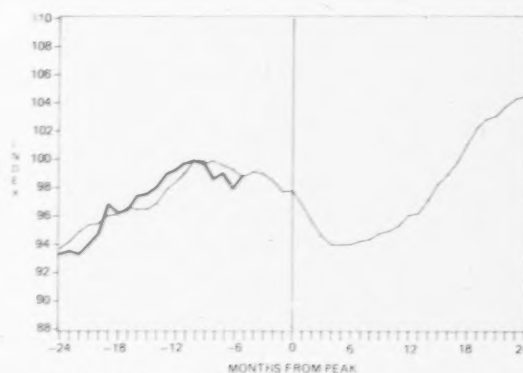
Some Misleading Statistics

But there are many signs of weakness that the more bullish economists may be ignoring. Take the leading indicators, for example. Chart I shows this index's current performance, measured against its behavior prior to and after seven previous business cycle peaks. The lines are arranged so that the peak of the current index coincides with the peak of the average of the past. As you can see, this series rarely moves in a straight line for very long, so its current behavior is not at variance with its behavior just prior to past economic peaks.

As for the labor force data, they, too, are not as strong as they appear. A big chunk of the payroll gains came in service industries,

much of which appeared to be either low-paying full-time jobs, such as those held by temporary employees, or part-time employment. This is suggested by the fact that the average hourly wage slipped a bit in February.

CHART I
LEADING INDICATORS:
CURRENT INDEX (THICK) VS.
AVERAGE OF PRIOR SEVEN RECESSIONS (THIN)



Meanwhile, factory payrolls went up by only 20,000 in the month. When combined with a drop in overtime and in the average workweek, this led to a near cessation of growth in factory output—the sector that was supposed to carry the economy forward this year! Manufacturing production rose at an annual rate of only 1.8 percent in February, after rising at a 7.3 percent pace in the previous four months.

Faulty seasonal adjustments may have also played a role. There were especially large increases in both construction and retail payrolls—rather unusual, when you remember how weak these two sectors were earlier in the year. The pace of new-home construction in the first two months of this year was 6½ percent below the average of the fourth quarter—and ran a thumping 20 percent below year-ago levels. And retail sales excluding autos fell sharply in January and probably dropped further in February, when you factor out inflation.

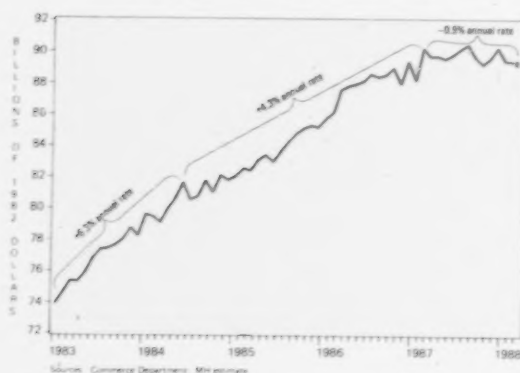
It's not hard to figure out why the consumer has zipped up his wallet. Savings are low,

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debt is high, and buying power has stopped growing. Last year, the savings rate dipped to a 40-year low. Not since 1947 was the savings rate as low as it was in 1987. By contrast, over the postwar period, people managed to sock away about 6¼ percent of their take-home pay; in the mid-1970s, people routinely saved more than eight percent of their paychecks.

Debt, on the other hand, is at record levels—not only in absolute terms, but, more important, as a share of after-tax income. If you add up installment and mortgage debt held by individuals at the end of last year, you will see that it equals more than 75 percent of take-home pay! And this is with fewer tax benefits because of tax reform. As for buying power, it hardly grew at all in 1987—gains in employment notwithstanding. This is because many people were unable (or unwilling) to keep up with inflation. Flatness in buying power is usually associated with recessions—not with expansions.

CHART II
REAL RETAIL SALES EXCLUDING AUTOS



Then there is that elusive element called confidence. While several surveys of consumer attitudes do suggest a rebound from the post-crash lows of last October, more telling, perhaps, is what has happened to household net worth as a result of the stock market's plunge. According to the Council of Economic Advisers:

"... consumer spending behavior appears to have become more cautious. The stock market is a barometer of confidence in the outlook, and it is a major component of the Nation's wealth. At the end of

September the market value of corporate equities totaled roughly \$4.4 trillion, about \$2.3 trillion of which was held directly by the household sector. This \$2.3 trillion represented nearly one-sixth of that sector's total net worth of \$15 trillion, so a large change in the value of stocks could be expected to have an impact on household spending. Some econometric models have estimated that a \$1 decline in the value of the stock market reduces consumer spending by about four cents over a horizon of roughly one year. Thus a \$500 billion drop in stocks would mean about a \$20 billion (or 0.8 percent) reduction in consumer expenditures by the fall of 1988."

Sales and Output Diverge

Not surprisingly, consumer spending has been weak for quite some time—going back even before the market's crash. Over the past year, consumer outlays excluding automobiles have fallen by one percent, after having risen at a four percent annual rate from the middle of 1984 to early 1987, and at a six percent clip from the beginning of the expansion, to mid-1984 (Chart II).

By contrast, output of consumer goods accelerated early last year. Not surprisingly, a pileup of unsold goods developed at all levels of production and distribution. First apparent at the retail level, excess stockpiles have spread to wholesalers, and are now impacting the nation's manufacturers. That's why factory output has turned sluggish.

As many readers must be aware by now, inventory accumulation accounted for over 80 percent of the growth in the fourth quarter's real GNP. At the same time, consumer spending fell, suggesting that most of this pileup was unintended. Yet, some economists profess not to be worried. They believe that there was some deliberate inventory building because of inflation fears, as well as because of surging exports. And they also think that a big chunk of the pileup of stocks at retail represented goods that came from abroad.

There's not much substance to these arguments. On the inflation front, while there is some price pressure in the production

pipelines (Economic Report—January 1988) it is clearly being capped at the wholesale and at the consumer level because of weak final demands. And if exports are surging, why should finished goods be piling up in warehouses? The ratio of manufacturers' work-in-process inventories to their finished goods inventories is now declining, after having risen sharply during the previous eight months.

As for the source of retail stocks being imports, two points should be noted:

1. Real imports of consumer goods have not grown at all since third-quarter 1986, while real retail inventories have climbed about 10 percent;
2. Regardless, inventories are part of the GNP accounts, thus any efforts to work them down will represent a subtraction from the first quarter's tally.

What about the export sector, you say? Surely there is strength here. Of course there is—but, once again, not as much as meets the eye. For one thing, the export industries account for only about 12 percent of GNP. This means that they would have to grow awfully fast to offset just a flattening in the much larger consumer sector.

For another, many companies that export are running at peak rates of speed; they simply cannot grind out the goods any faster. Even if they could, who would buy the goods, considering how weak Europe is and that we don't sell much to Japan and to Latin America? The fact that exports fell in January by nearly twice as much as they usually do may be an indication that some exporters are bumping up against limits to growth—either in terms of capacity utilization, or in weakness in overseas economies.

Our Shifting Trade Gap

Finally, although American industry has become more competitive compared with Japan and the industrialized nations of Western Europe, it has not materially improved its position against a number of other countries. This is because, while the U.S. dollar has fallen a lot against the Japanese yen, as well as against the currencies of the

industrialized European countries, it has not fallen very much either against the currency of our biggest trading partner, Canada, or against the currencies of the so-called "Four Tigers" of the Pacific Basin—South Korea, Singapore, Hong Kong and Taiwan.

Since reaching a peak in late February, 1985, the U.S. dollar has dropped by about 50 percent against the Japanese yen, German mark, Swiss franc and Dutch guilder, and close to 45 percent against the other major European currencies. However, against the Canadian dollar, the U.S. unit has declined by less than 10 percent. And even with the Canadian dollar now at a four-year high, it remains undervalued against the U.S. dollar. This is a major reason why our bilateral trade deficit with Canada remains large.

Far more serious is the dollar's performance against the "Four Tigers." As was first reported 18 months ago (Economic Report—September 1986) these newly industrializing countries of Southeast Asia represent one of the fastest growing components of U.S. trade. Our two-way trade with these countries has increased from \$11 billion in 1975, to \$85 billion last year. At the same time, our trade deficit with these countries soared from less than \$500 million, to \$38 billion last year. Three of the four "Tigers" are now in the top ten in terms of our two-way trade, and they are moving up in the deficit rankings, too. Our trade deficit with South Korea ranked number five last year; four years earlier the country wasn't in the top ten. And Taiwan has jumped from our eighth largest deficit trading partner in 1981, to rank number two last year! Thus, even as we are reducing our trade deficit with Japan and Germany, we are increasing it with the Pacific Basin countries. This will limit the overall reduction in our trade deficit, thus its contribution to economic growth.

The bottom line: It appears as though there was little or no growth in the first quarter's GNP. And if this is true, there could well be a repeat performance in the second quarter—especially if inventories remain top-heavy and corporate, consumer and investor attitudes darken. ■



Vitality

"...We look for stronger operating earnings in 1988 based on three fundamentals—further success in managing our businesses for higher returns, lower operating expenses and a continued improvement in credit quality..."

Extracted from a letter to shareholders by the Chairman, John F. McGillicuddy.

Restoring common shareholders' equity to four percent, the ratio prior to the restructuring action, is our overriding priority. We intend largely to accomplish this objective by the end of 1988 through a combination of gains from the sale of undervalued assets, the realization of tax benefits resulting from the addition to the reserve, and stronger operating earnings.

Asset Sales

During 1987, as part of the equity restoration process, we realized \$150 million pre-tax from the sale of undervalued assets. We continue to have substantial amounts of undervalued assets on our books. By selling a portion of them, we anticipate pre-tax gains in 1988 of \$400 million—\$230 million after tax, but before tax benefits relating to the reserve decision.

Tax Benefits

In 1987, the full impact of the restructuring action was mitigated by the ability to apply \$277 million in tax benefits. In 1988, we will have the capacity arising from operating earnings and gains from asset sales to apply approximately \$200 million of the remaining \$342 million of tax benefits relating to the restructuring action.

Operating Earnings

While tax benefits and special gains will be essential to rebuilding equity in 1988, it is the renewed strength of our basic businesses that will make the major difference this year and in the years ahead.

"We look for stronger operating earnings in 1988 based on three fundamentals—further success in managing our businesses for higher returns, lower operating expenses and a continued improvement in credit quality as was evident in the fourth quarter of 1987."

Manufacturers Hanover has strong

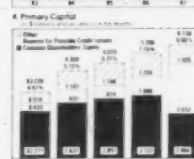
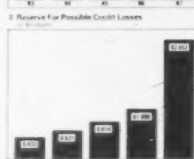
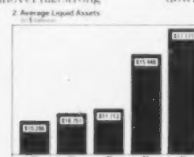
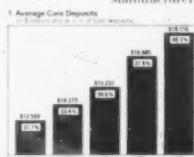
amounting to \$117 million. This primarily related to the exiting of businesses, a further sharpening of focus in selected markets, the closing of domestic offices and a planned staff reduction of approximately 2,500. With this reduction, total staff will have been scaled down by approximately 5,400 positions, or 17 percent, since the beginning of 1986.

The restructuring portion of the fourth quarter charges amounted to \$82 million, but will result in an earnings benefit going forward of approximately \$95 million a year.

"Improved results were largely masked in 1987 by the restructuring action in June and the fourth quarter restructuring charge. Progress was broadly based. For example, trading revenues increased 47 percent to \$161 million. Earnings from consumer banking increased 22 percent to \$116 million. Net income for the Corporate Banking Sector totaled \$166 million, up from \$90 million in 1986."

Also masked was our institution's continued success in controlling overhead. Without the restructuring and other special charges, operating expenses would have been up only 3.3 percent for the year—among the best performances for a money center bank. Expense control remains an imperative. We expect operating expenses in 1988 to be lower than last year's level.

In summary, with a number of major restructurings behind us, the real value of our business franchises will begin to be reflected in stronger operating earnings.



franchises in place within profitable segments of three key markets.

Also in place is an effective profitability discipline to make these businesses pay off in higher returns. It proceeds from the logic that managing for higher returns dictates that we exit, sell or downsize businesses that no longer meet our targets while directing additional resources to the most profitable segments of our markets. The objective is clear—to enhance shareholder value.

Managing for higher returns formed the basis of the restructuring and other special charges we took in the fourth quarter.



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Economic Report

June 1988

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Irwin L. Kellner
Chief Economist

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Where's the Recession?

As the U.S. economy prepares to round the midyear turn, it seems fairly obvious that it did not lapse into the recession that many economists had expected to occur right after the stock market's collapse last October. To be sure, spending patterns did change abruptly. Sales of new cars and new homes plunged in fourth-quarter 1987 compared with the third. Indeed, domestic purchases by both consumers and business fell at an annual rate of $1\frac{1}{2}$ percent, following a rise at a rate of nearly $7\frac{1}{2}$ percent in the third quarter. However, outlays rebounded in 1988's first quarter, and have apparently risen further in the second. This has allowed business to work down some of the inventories that piled up late last year, in the wake of the spending cutbacks, without having to slash output schedules to the point of laying off workers, thus impacting confidence and buying power.

Does this mean that the worst is over? Or could it be that the recession has merely been postponed, rather than cancelled? Here are some questions concerning the outlook:

You've been forecasting a recession for 1988, yet, if anything, the latest batch of economic statistics seems to suggest just the opposite—an economy that's on the verge of overheating, with rising inflation and interest rates.

Exactly why we expect a recession! That's how they usually begin: An ebullient economy leads to faster increases in prices, which, in turn, cause the Federal Reserve to tighten the credit reins, boosting interest rates in the money markets. Bond market rates go up as inflation expectations heighten, and both produce a decline in stock prices. This leads to a drop in wealth and confidence among consumers, who usually respond by reducing their spending, leaving business with a pile of unsold goods. As business cuts excess inventories, people lose their jobs, spend less, and the process is repeated enough to produce a recession.

But didn't you expect a recession to begin earlier, right after the stock market crashed?

Yes, we did. As a matter of fact, even *before* the stock market crashed, we were predicting that the economy would enter into a recession sometime late in 1987 or in early 1988. In forecasting a recession for 1988, we expected the stock market to decline, because that's what usually happens prior to recessions. Last August, for example, we were about the only group looking for stocks to end 1987 at much lower levels than they were at that time. We clearly did not expect the decline to come all at once; the ensuing crash, like a summer thunderstorm, had the effect of cooling off the economy, which was experiencing rising inflation and interest rates. The Fed loosened monetary policy, interest rates came down, the dollar jumped in foreign exchange markets, and inflation pressures were suppressed.

You have said on previous occasions that, while not every decline in stock prices has led to a recession, the only time in this century when a plunge in stock prices the size of the decline between August 25, 1987 and October 19, 36 percent, was *not* followed by a recession was just at the start of World War II, when the military buildup offset the depressing effects of a big plunge in stocks. Obviously, we are not at war today, so how do you explain the fact that, after a brief dip, spending is once again climbing?

First of all, one should be aware that the stock market has risen close to 13 percent since October 19. That's helped to boost confidence, somewhat. In addition, it would appear that the market ran up so fast earlier in 1987 that few people realized they had such strong gains. In addition, most still have a profit in stocks they've held onto, and relatively few people own stocks directly, anyway. Combine all this with the drop in interest rates, and the aging expansion received a new lease on life from a development that practically everyone expected would do just the opposite.

Then why are you still looking for a recession?

From another development that practically everyone thinks will do the opposite—what appears to be current strength in domestic spending and production. Even with April's decline, retail sales were running at a rate some 3½ percent ahead of the first quarter's levels. For its part, industrial production surged by an annual rate of eight percent in April, after having risen at a tepid 2½ percent clip in the first quarter. Along with such other seemingly bullish statistics as the employment and unemployment data, these figures have dissipated recession concerns and brought on euphoria. But they have also led to increased fears of inflation, and a jump in interest rates.

Well, if the economy is this strong, can't it withstand a mild dose of tighter money and higher interest rates?

Who is to say that the recent round of monetary tightening and rising interest rates has ended? The fixed-income markets may not be satisfied until there's enough evidence that the economy is cooling off. And by then, it may be too late to avert a recession.

Why do you say that?

Because the economy is not as strong as it looks. Spending by half of the private economy was lower in the first quarter of 1988 than it was back in third-quarter 1986! By this, I mean actual consumer purchases of hardgoods, softgoods, spending on housing, and business outlays for physical plant. Consumption of goods in particular has declined about 2½ percent over the past 18 months. At the same time, production of goods destined for consumers has jumped by nearly seven percent.

Are you suggesting that inventories are too high?

Yes. And while there was a decline in the rate of inventory accumulation reported in the first quarter's GNP, it seems to be insufficient, given what other data indicate—and given the fact that 80 percent of the growth in the previous quarter was accounted for by a jump in stockpiling.

Then you believe that capacity pressures are not as bad as they seem?

Once business realizes that it is producing far in excess of final sales, output growth will moderate and capacity utilization will decline. But even at April's levels, capacity use is not as intense as it appears. For one thing, while the overall operating rate may be at an eight-year high, at 82.7 percent, April's rate was more than four percentage points below December 1978's high. What's more, there were about a dozen major industries that in April were operating below rates reached as recently as August 1984! The really high rates you've been reading about are confined to only a few industries.

Then how do you explain the surge in business spending on equipment?

Easy. Businessmen have concluded that they cannot rely only on the value of the dollar to help restore their competitiveness both here and abroad. For one thing, the dollar is down significantly only against the major currencies, and not against such others as those of the Pacific Basin developing countries—the source of more and more of our imports. For another, who can guarantee that, even where it has fallen a lot, the dollar will stay down? Installing the newest machinery and equipment will enable companies to produce goods more efficiently—that is goods of higher quality at a lower cost—but it won't necessarily add to capacity. As a matter of fact, spokesmen for several major corporations have stated that they do not wish to add to capacity—although they do want to be able to produce more efficiently.

The latest figures show a substantial improvement in our trade deficit. Since imports are still rising, this must mean that the nation's exporters are enjoying a significant increase in demand. Doesn't this help the economy?

It definitely helps some industries and those regions of the U.S. where manufacturing is concentrated. However, keep in mind that exports make up only 10 percent of our GNP—they can't keep us out of recession all by themselves.

But surely, rising exports will help reduce our trade deficit.

It can't hurt—but I would not count on

exports alone to solve this problem. For one thing, imports are more than half again as large as exports; the trade deficit would shrink faster if imports were to come down as well. Second, many exporting industries are running at top speed; they cannot produce any faster. Third, most of our trading partners are either restricting imports from us, or are experiencing softness, themselves. Finally, as noted above, the sources of our trade deficit seem to be shifting away from Japan and Europe, to the "Four Tigers" of the Pacific Basin (Hong Kong, Singapore, South Korea and Taiwan), against whose currencies the U.S. dollar remains overvalued.

You say that the economy is weak, and that we may be heading into a recession. Yet, most economists and the markets fear the opposite—they think the economy is so strong, that we're more likely to overheat and experience a return to rapid inflation. What are they looking at that leads them to this conclusion?

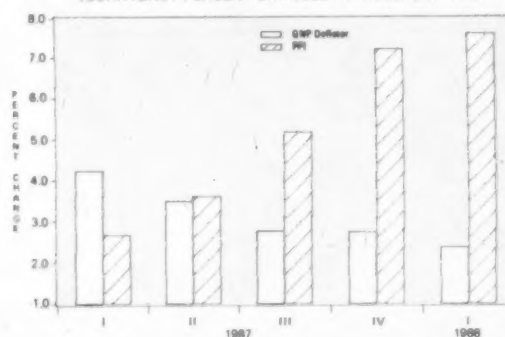
Besides looking only superficially at capacity utilization, those who are worried about resurging inflation are focusing on such developments as the 45 percent jump in prices of industrial raw materials since August 1986; the progressively faster rise in producer prices of intermediate goods excluding food and energy since the middle of that year; April's fourteen-year low rate of unemployment, along with the record rate of employment, and the recent runup in foodstuffs' prices.

Doesn't this worry you, too?

While one should always be vigilant when it comes to inflation, it's not at the top of my worry list at the present time. For one thing, prices of two very important items—oil and labor—are *not* climbing steeply. Crude oil prices are well below their highs of last summer—not to mention two years earlier, when the posted price was \$28 per barrel. And while labor markets may appear tight, labor does not seem to be either willing or able to translate this into higher wage rates, since labor costs per unit of output have risen only about two percent over the past year—half the rate of two years ago, and only a fraction of the double-digit rates common between 1979 and 1982. For another, people—both consumers and

businessmen—are resisting paying higher prices, witness the progressively *slower* rate of rise of the GNP price index, or deflator, over the past four quarters (chart). Of all the measures of inflation, this is the most accurate, because it reflects current consumption patterns—not those of some earlier period. In other words—people are shunning those goods whose prices are rising more rapidly, and are buying instead, those goods whose prices are going up more slowly, if at all.

GNP DEFLATOR VS. PRODUCER PRICE INDEX FOR INTERMEDIATE GOODS EXCLUDING FOOD AND ENERGY (QUARTERLY PERCENT CHANGES AT ANNUAL RATES)



And they are able to enforce this price discipline on the economy because of the weakness you referred to earlier?

That's correct. This is the other side of the fact that spending by half the private economy was lower in first-quarter 1988 than it was 18 months earlier.

What will happen if interest rates continue to rise?

They will slow aggregate economic activity the way they've already affected housing, which in April was 4½ percent below year-ago levels. It won't take much more of a rise to reduce sales of such other big-ticket consumer items as autos, home appliances and household furnishings, since consumer debt is at a record high relative to income, savings rates are below average, and buying power is virtually flat. Needless to say, rising interest rates are anathema to stock prices, so another sharp drop in prices of equities could develop which would also push the economy lower by cutting into both wealth and confidence, and by making it more difficult for business to raise money. Thus the long-expected recession would finally arrive, albeit a bit late—and when least expected.



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Economic Report

August 1988

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Irwin L. Kellner
Chief Economist

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Business Conditions Update

Release of data covering the second quarter's gross national product, following such other developments as the drought in the farm belt and the earlier runup in prices of industrial raw materials, has shifted the markets' focus from fears of recession to fears of inflation. Although economic growth slowed a bit, the GNP deflator—which measures prices of goods actually purchased—rose at the fastest quarterly rate in four years. What is more, since monthly statistics suggest that the second quarter ended on a rising note, it is not improbable that the current quarter will reflect more growth—thus fanning more inflation fears.

Considering the age of the expansion, plus the fact that both the labor force and the capacity figures indicate that the economy is reasonably fully employed, you would think that the GNP results would be greeted positively by the financial markets. Not so: stocks, bonds and the dollar all fell.

What's going on? Are the markets sadists, or is this an Alice-in-Wonderland economy, where good news is bad news and vice-versa?

New Fears of Inflation

I think it has to do with latent concerns over inflation. Notwithstanding the fact that the annual rate of inflation has remained below four percent every year from 1982 through 1986 (a year that saw the 12-month increase in the consumer price index slow to only 1.1 percent—the slowest for any 12-month period in 21 years) and that 1987's rise in the CPI was only 4.4 percent, fears of inflation still affect Wall Street's thinking.

For one thing, the markets note that the Federal Reserve's Board of Governors consists of six people relatively inexperienced in central banking—all of whom were appointed by the same President. Considering that the Presidential election campaign is now getting into high gear, you can't blame the markets for worrying that the Fed might put political considerations ahead of eco-

nomic needs in managing the growth of money and the level of interest rates. The last time all Fed board members were chosen by the same President (thus, presumably, being all of the same political persuasion) was during the Administration of President Franklin D. Roosevelt.

Of course, most Fed members leave their political beliefs outside the door when they enter the central bank—but try telling the markets this, in view of the Fed's past performances during election years. Other than Paul Volcker's tightening of money shortly after President Carter appointed him in August 1979 (which ultimately set the stage for the mini-recession of 1980 and for Mr. Carter's loss to Ronald Reagan), the Fed has conducted monetary policy in such a way as to benefit the incumbent party. This is because it has traced a low profile by keeping money growth steady and interest rate changes moderate. True, this tends to be good for the economy—but what's good for the economy in an Election year, is usually good for the party in the White House.

If the economy were soft, the markets probably wouldn't begrudge the Fed a little easing. However, the economy does not seem soft; its growth of 3¼ percent in the first half of 1988 was a far cry from the recession that was widely expected in the wake of the stock market's crash last October. Reflecting this apparent strength (plus the decline in the foreign exchange value of the dollar against the major currencies between February 1985 and the end of last year) prices of most industrial raw materials have shot up. After hitting a low back in August 1986, the Commodity Research Bureau's Spot Price Index of 13 industrial commodities rose nearly 47 percent before tapering late in June.

On top of this, prices of foodstuffs have soared because of the drought in the Midwest. The CRB's Spot Price Index of 10 food commodities jumped about 22 percent earlier this year, and even after its recent decline stands at one of its highest levels in about three years. Compounding this is the

fact that capacity use in June was at its highest point in over eight years, while the jobless rate at midyear stood at a 14-year low.

Some Offsetting Factors

Are the markets justified in their concerns over inflation, or are there some mitigating factors that are being overlooked? I believe the latter is the case. For one thing, the price of one item that makes up at least two-thirds of business costs, labor, is still going up at a moderate pace. Although hourly earnings are rising at the fastest rate in about five years, because of advances in productivity, labor costs per unit of output rose only slightly faster in the past six months than they did in the previous half-year.

Then there is oil. Even before the cease fire between Iran and Iraq was announced, oil prices were heading lower. The benchmark West Texas Intermediate's spot price touched \$14.45 per bbl in the middle of last month, down from nearly \$17 several weeks earlier, and \$22.50 last summer. And this occurred after the North Sea fire which had the effect of removing some 500,000 b/d from the market. Although some believe that peace in the Middle East could boost oil prices, I would remind you that both Iran and Iraq are major oil producers whose needs for funds to rebuild their economies are obviously urgent. In order to obtain these funds, they will doubtless repair their oil producing facilities and begin pumping as much as possible. At their respective peaks in the mid-1970s, these two countries produced over eight million b/d—twice their recent combined output. Unless matched by output declines elsewhere, this will depress oil prices by at least several dollars a barrel—holding down inflation in the process.

As far as other commodities are concerned, prices of industrial raw materials appear to have topped out. Whether it is because of developing softness in the U.S. economy (table), or because of the dollar's rebound in the foreign exchange markets remains to be seen. The point is that, for the moment, anyway, price pressures from this source are clearly less intense. On the food front, the picture may not be so bleak, either. For one thing, rains have rescued some of the crops that had been threatened by the earlier dry spell. And those crops that have been reduced are either in good supply in the government's storage bins, and/or are available from other countries, whose growing seasons were not adversely impacted by the weather.

Keep in mind that prices of some food products are actually falling as a result of the drought. Ranchers have stepped up shipments of meat animals to markets, rather than be faced with significantly higher feedgrains' costs. Remember, also, the fact that farmers get only about 30 percent of the retail food dollar, so an increase of even 25 percent in prices received by farmers trans-

lates into a rise of only 7½ percent at retail—assuming that the various middlemen do not add a markup of their own. And foods represent only about one-fifth of consumers' budgets, so this would result in a one-time addition of only 1½ percentage points to the consumer price index, all-other things equal.

But all other things are not equal. The drop in oil prices referred to earlier pulled down energy prices in June—the first monthly decline since February. And clothing prices declined in June after flattening in May, suggesting resistance on the part of consumers to the earlier sharp runup. Indeed, price resistance still seems to be

MH FORECAST OF G (Seasonally Ad In

	1987			
	1	2	3	4
Gross National Product	4377.7	4445.1	4524.0	4607.7
GNP: \$82	3776.7	3823.0	3865.3	3923.0
% Change, Annual Rates	4.6	5.0	4.5	6.0
Consumption \$82	2490.2	2516.6	2545.2	2531.0
Durables \$82	378.3	391.3	406.5	381.0
Non-Durables \$82	889.9	889.8	891.9	890.0
Services \$82	1222.0	1235.5	1246.8	1253.0
Investment \$82	646.4	660.2	667.9	724.0
Non-Residential \$82	418.2	434.8	462.8	464.0
Producers Durable Equip. \$82	297.2	313.8	334.7	332.0
Structures \$82	121.0	120.9	128.0	132.0
Residential \$82	198.4	197.6	192.1	192.0
Inventory Changes \$82	29.8	27.8	13.0	67.0
Net Exports \$82	-132.8	-126.0	-130.7	-126.0
Exports \$82	394.9	416.4	440.9	459.0
Imports \$82	527.7	542.3	571.6	585.0
Government Purchases \$82	759.6	766.7	771.7	788.0
Federal Defense \$82	257.0	264.8	269.5	268.0
Federal Civilian \$82	77.0	67.3	72.6	79.0
State & Local \$82	438.9	440.1	440.8	444.0
Final Sales: \$82	3746.9	3795.2	3852.2	3855.0
% Change, Annual Rates	0.2	5.3	6.1	0.0
Domestic Demand: \$82	3909.5	3948.9	3996.0	4049.0
% Change, Annual Rates	3.4	4.1	4.9	5.0
Final Dom. Private Demand \$82	3120.1	3154.5	3211.2	3193.0
% Change, Annual Rates	0.6	4.5	7.4	-2.0
GNP Price Index (1982 = 100)	116.3	117.3	118.2	118.0
% Change, Annual Rates	3.5	3.5	3.1	2.0
Consumer Price Index (1967 = 100)	335.0	339.0	342.3	345.0
% Change, Annual Rates	5.3	4.9	3.9	3.0
Total Personal Income	3676.1	3736.1	3801.0	3906.0
Disposable Personal Income	3143.9	3154.1	3224.9	3315.0
Savings Rate	4.2	2.2	2.3	4.0
Unemployment Rate	6.6	6.2	6.0	5.0
Indus. Production (1977 = 100)	126.9	128.2	130.9	133.0
Housing Starts (000)	1778.7	1605.7	1618.7	1532.0
Domestic Auto Sales (000)	6684.3	7094.3	7977.3	6568.0
Dom. Auto & Lt. Truck Sales (000)	10120.3	10894.3	12064.1	10385.0
Corporate Pre-Tax Profits	261.8	273.7	289.4	281.0
Net Profits	135.5	141.1	149.5	145.0
Net Cash Flow	371.4	374.0	384.8	384.0

*Forecast

the order of the day. The price index that is part of the GNP accounts rose at an annual rate of less than three percent in the first six months of this year, compared with the CPI's 4½ percent jump. As previously pointed out, GNP-based indexes measure prices only of those goods consumed. They are shifting-weight, not fixed-weight indexes, like the CPI, or the Producer Price Index. The implication: People continue to shun those goods whose prices are rising rapidly in favor of those whose prices are going up more slowly, or not at all.

On another front, the inflation bears are worried that the economy is running out of room to grow. They

point to the jobless rate, which, as noted above, touched a 14-year low in June, and to the capacity utilization rate, which hit an eight-year high. In both cases, I would argue that there is still room to spare. The jobless rate, as you may recall, has been lower than June's 5.3 percent. In fact, it averaged 4½ percent from 1948 through 1973—a period that included five recessions, besides two wars. What is more, even though employment, both in numbers and as a percent of the non-institutional population over 16, was at a record at midyear, there remain more than 63,000 people who are over the age of 16 and not in institutions who could be available for work. If only 10 percent of these people were to decide simultaneously that they wanted work and none found a job right away, the jobless rate would nearly double.

Taking a look at capacity utilization, the eight-year high reported for June was lofty only in comparison with the past eight years. When compared with earlier periods, June's 83 percent rate of capacity use was not great at all. The ratio was nearly four points higher back in December 1978, and was over 90 percent on more than one occasion, back in the 1960s. At midyear 1988, by contrast, only two major industries' operating rates were higher than 90 percent, while only two others were above 88 percent. Most were in the low to mid-80s, and a few were actually running below 80 percent of capacity.

Interest Rates Should Stabilize

Nevertheless, as you may have gathered by now, my arguments neither determine market psychology, nor have much effect on interest rates, stock prices, etc. That being the case, I am cognizant of the fact that interest rates have risen in recent months, presumably because of inflation fears. The bellwether 30-year Treasury bond yield at the end of July was reaching for its highest level since the stock market crash, while Federal funds, representing short-term rates, have climbed by 1½ points from their February lows.

However, I don't think interest rates will move much higher—at least over the balance of this year. Long rates should stabilize as long as the actual inflation rate remains moderate. On the short end of the market, it is difficult to envision the Federal Reserve pushing rates up. For one thing, a Federal funds rate much above eight percent would encourage the banks to borrow from the cheaper discount window, where the rate is only six percent. This would negate the Fed's tight money policy. Of course, the Fed could boost the discount rate. However, the last time that happened, September 4, 1987, it was followed by the collapse in stock prices six weeks later. Election year considerations aside, then, a discount rate increase would appear to be a risky move, considering the state of the stock market and the uncertainties over the course of inflation and the economy.

Just, 1988 GROSS NATIONAL PRODUCT (Adjusted Annual Rates) Billions

		< Actual Projected >					
YEAR 1987		1988				YEAR 1988	
LEVEL	% CH	1	2	3	4	LEVEL	% CH
4488.5	6.0	4665.1	4712.7	4879.6	4934.0	4797.8	6.9
3847.0	3.4	3956.1	3986.3	4012.0	4025.6	3995.0	3.8
2520.9	2.7	2559.8	2574.2	2586.6	2596.5	2579.3	2.3
390.9	1.5	401.1	408.1	410.4	410.6	407.5	4.3
890.5	1.3	892.7	888.2	890.8	890.6	890.6	0.0
1239.5	4.1	1265.9	1278.0	1285.4	1295.4	1281.2	3.4
674.8	4.9	728.9	725.0	710.0	699.5	715.9	6.1
445.2	2.8	473.4	489.2	493.6	489.5	486.4	9.3
319.6	5.2	349.4	361.7	365.1	364.6	360.2	12.7
125.5	3.0	124.0	127.5	128.5	124.9	126.2	0.6
195.2	0.1	189.5	190.8	190.7	188.3	189.8	-2.8
34.4		66.0	45.0	25.7	21.7	39.6	
-128.9		-109.0	-90.1	-70.1	-65.2	-83.6	
427.8	13.1	486.2	495.6	509.7	514.9	501.6	17.2
556.7	7.9	595.1	585.7	579.8	580.2	585.2	5.1
771.7	2.6	766.0	776.1	785.4	794.9	780.6	0.4
264.9	5.3	264.6	260.9	259.9	259.8	261.3	-1.3
74.1	9.6	63.2	64.4	70.0	74.9	68.1	-8.1
441.2	3.3	448.7	451.9	455.4	460.2	454.0	2.9
3812.5	2.9	3890.1	3941.3	3986.3	4003.9	3955.4	3.7
2.9		3.6	5.4	4.6	1.8	3.7	
3975.9	3.0	4065.0	4076.4	4082.0	4090.9	4078.6	2.6
3.0		1.6	1.1	0.6	0.9	2.6	
3169.7	2.6	3233.1	3255.3	3270.9	3274.3	3258.4	2.8
2.6		5.1	2.8	1.9	0.4	2.8	
117.7	3.3	119.4	120.6	121.6	122.6	121.0	2.9
3.3		1.7	4.1	3.4	3.1	2.9	
340.4	3.7	348.3	352.4	355.6	358.7	353.7	3.9
3.7		3.4	4.8	3.7	3.5	3.9	
3780.0	7.0	3951.4	4017.2	4041.7	4098.8	4027.3	6.5
3209.7	6.3	3375.6	3416.5	3457.3	3502.9	3438.1	7.1
3.3		4.4	3.8	4.2	4.5	4.2	
6.2		5.7	5.4	5.6	5.9	5.7	
129.8	3.8	134.5	136.0	138.4	140.4	137.3	5.8
1633.9	9.8	1479.7	1474.0	1509.2	1508.8	1492.9	-8.6
7081.0	13.8	7640.0	7473.3	7310.3	7304.5	7432.0	5.0
10866.0	8.7	11778.8	11642.1	11352.1	11477.5	11562.6	6.4
276.7	17.1	286.2	254.3*	314.8	305.5	290.2	4.9
142.9	10.2	149.4	133.4	163.8	157.0	150.9	5.6
378.6	-2.0	387.9	361.8	391.3	383.8	381.2	0.7



Vitality

"Our plan is on track."

Shareholders' equity up \$776 million

Manufacturers Hanover Corporation reported earnings of \$403.1 million for the second quarter, or \$7.93 per common share, and major progress toward its goal of restoring common equity to four percent of assets. It also reported a \$250 million reduction in nonperforming assets during the quarter and lower operating expenses.

Highlights for the second quarter include:

- An increase in common shareholders' equity to 3.60 percent of total assets, up from 2.36 percent at June 30 last year. The addition of \$776.3 million in common equity over the past twelve months brings total common shareholders' equity to \$2.52 billion, up 45 percent from \$1.74 billion a year ago. At June 30, primary capital stood at 8.56 percent of assets and total capital was \$9.7 billion, or 13.40 percent of total assets.
- An increase in common shareholders' equity at Manufacturers Hanover Trust Company, the Corporation's flag-

ship bank, to 4.06 percent of assets, up from 2.80 percent a year ago. The Trust Company's primary capital at June 30 stood at 8.59 percent of assets.

- Net income of \$403.1 million, or \$7.93 per common share. These results include a gain of \$291.3 million (including tax benefits) from the sale of the Corporation's consumer finance subsidiary, Manufacturers Hanover Consumer Services, Inc., as part of its equity replenishment plan. For the first six months, net income was \$543.4 million, or \$10.52 per common share.
- A \$250 million reduction in nonperforming assets in the past three months and a \$521 million reduction in the past year. Nonperforming loans have been down for four consecutive quarters.
- Earnings of \$31.8 million at The CIT Group, more than double the \$13.9 million reported in the second quarter a year ago. For the first six months, earnings at CIT were \$62.0 million, up 61.8 percent from \$38.3 million last year.

Chairman and Chief Executive Officer John F. McGillicuddy said, "The addition of nearly \$800 million in common equity reflects success in our plan to largely restore common equity by the end of 1988 to four percent of assets—approximately the same level prior to last year's reserving action. Our overall results demonstrate that the key fundamentals of our financial plan—managing our business for higher returns, lower expenses and improving credit quality—are on track with expectations.

"Because our capital-raising actions since last June focused on common equity, they are consistent with the new regulatory requirements for risk-adjusted capital. We are confident that Manufacturers Hanover will be well within the requirements as they are phased in."

Mr. McGillicuddy added, "The results at CIT begin to underscore the potential of this organization. In addition to the efficiencies effected through the restructuring of CIT, charge-offs and operating expenses are substantially below last year's levels."



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